

# **Bond Case Briefs**

*Municipal Finance Law Since 1971*

---

## **Regulators' Proposal To Exclude Munis From HQLA Status To Dent Demand.**

Bank regulators' recent proposal to exclude municipal bonds from the standards for receiving HQLA status would impair Munis' demand, notes Citi in its recent report.

George Friedlander and others at Citi Research believe a very strong case exists for including a very large proportion of investment grade municipals as HQLA. They believe municipal bonds should be given level 2A status in many cases and level 2B status in most other cases.

Several reasons for inclusion of Munis as HQLA

Recently, bank regulators proposed a set of standards that would, among other things, measure the extent to which bank holdings would meet certain standards as High Quality Liquid Assets.

According to Citi analysts, there are several compelling factors for inclusion of municipal bonds as HQLA.

For instance, the analysts point out that during 2008, when the capital markets received their most severe tests in recent decades, both municipal general obligation bonds and revenue bonds held their value better than higher-grade and lower investment grade corporates. Furthermore, they did so roughly as well as GSE secured bonds such as those issued by Freddie Mac / Federal Home Loan Mortgage Corp (OTCBB:FMCC).

Commercial banks holdings in munis

As can be deduced from the above table, the net increase in holdings of municipal bonds by commercial banks is much greater than that of municipal bond funds. Citi analysts anticipate erosion in the value of outstanding municipal bonds without the support from commercial banks. Such a situation would also accentuate the borrowing costs of state and local governments.

Citi analysts also note the continuing superior credit strength and default history of municipal bonds in comparison with other similarly rated credits also strengthens their view for inclusion as HQLA.

The analysts also point out under Moody's credit standards, the average investment grade municipal bond (by count, not volume) is rated AA3, while the average corporate bond is rated Baa1.

Other factors justifying Munis' inclusion as HQLA

George Friedlander and team at Citi Research believe a number of sectors with greater gap-down risk than munis have been given potential HQLA standing, while municipals have not.

Furthermore, the analysts believe the following key factors also provide a strong case for inclusion of munis as HQLA and would reduce the liquidity risk profile of banks rather than increasing it. These factors are: the collapse of the municipal bond insurance sector, the severe erosion of the

variable rate market as a source of capital, the collapse of the auction rate securities market, the rapid erosion and virtual disappearance of leveraged, hedged holders of municipal bonds between 2007 and 2008.

Citi analysts also believe the Agencies should adjust for the higher credit strength in the sector and for the capacity of the market to evaluate CUSIPs for a given issuer that do not trade, based upon spread to the MMD high-grade curve for those that do. The analysts opine that it would be consistent with international standards as well as public policy to include municipal securities as HQLA in the same manner that foreign state obligations are already included in the proposed rule.